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May 1, 2006

Commissioner Jeff Hatch-Miller
Commissioner William Mundell
Commissioner Marc Spitzer
Commissioner Mike Gleason
Commissioner Kristin Mayes
1200 West Washington Street
Phoenix, Arizona 85007

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Re: FERC Order Revoking APS Market-Based Rates in the APS Control Area
(Docket No. E-01345A-05-0827)

Dear Commissioners:

On April 25, 2006, Arizona Public Service Company ("APS" or "Company") representatives met with your Staff to discuss the April 17th Order from the Federal Energy Regulatory Commission ("FERC"). During that meeting, it was suggested that the Commissioners should be similarly informed about this development and its impact on APS. We determined that a letter placed into the public record would be the best vehicle for such information to be provided. As discussed below, APS strongly believes that the FERC Order is both factually inaccurate and legally infirm. The Company will seek rehearing of that order on or before May 17, 2006, and, if necessary, appeal FERC's decision. With that introduction, let me now discuss the FERC Order itself.

On April 17, 2006, FERC issued an order revoking market-based rates of APS and its affiliates (the Pinnacle West Companies) for wholesale sales in the APS control area, effective February 27, 2005, the refund effective date previously established by FERC. APS and its affiliates remain authorized to sell at market-based rates in all other areas, which include the major market hub of Palo Verde¹, and are still authorized to sell within the control area at cost based rates. Also, the order did not find that APS either possessed market power or engaged in any anti-competitive conduct.

FERC, with Chairman Kelliher dissenting, states that the revocation of market-based rates is due to supposed deficiencies in the simultaneous transmission import capability limit ("SIL") study

¹ The April 17 Order also terminates certain financing and accounting waivers and blanket authorizations granted to public utilities with market-based rates, including a blanket authorization under Section 204 of the Federal Power Act to issue securities and assume liabilities. With termination of such blanket authorization, PWCC was required to obtain prior authorization from FERC for any such actions, except for short-term debt within certain limits. On April 19, 2006, PWCC filed a motion for a stay of the provisions of the April 17 Order terminating blanket authorization under Section 204 until May 3, 2006, to give FERC time to act upon a Section 204 application to be filed by PWCC. The requested stay was granted the same day and on April 20, 2006, PWCC filed its 204 application and requested FERC action on it on or before May 3, 2006.

that APS and its affiliates filed. These SIL studies calculate how much external generation can simultaneously reach the control area market in FERC's market power screen analyses². The scope and methodology of the SIL studies differ from the reliability must-run studies (RMR) that the Company is required to file with the ACC in that the SIL studies analyze the entire control area, rather than just the load pockets. Chairman Kelliher's dissent argues that, unlike other utilities, APS and its affiliates were not given sufficient notice of the alleged deficiencies in its SIL studies and an opportunity to address them.³ Chairman Kelliher noted that these calculations are not simple ones, and that APS and its affiliates had raised concerns about their inability to determine exactly what FERC was looking for in the studies. He also notes that it was only in the April 17 Order that APS and its affiliates were informed of certain of the deficiencies found by FERC.

APS was very surprised by the April 17 Order. There was no hearing in the case. The only evidence in the record is that submitted by APS and its affiliates, which demonstrates that they pass the FERC market screens. No evidence or other materials were submitted by FERC staff. Under FERC rules and procedures, the order itself was not available until it was issued. The order was never discussed at an open FERC meeting. APS was never informed prior to issuance of the order of what it might contain, was not given any opportunity to comment on it, and has had no communications from FERC for several months with respect to the SIL issues.

As for the order itself, APS concurs with Chairman Kelliher's strongly worded dissent, that the order is "legally infirm" for failure to provide APS of any notice of the alleged deficiencies in the SIL studies. APS also strongly disagrees with the April 17 Order's mischaracterization of the repeated efforts of APS and its affiliates to submit any and all information required or requested by FERC and its staff. Due to initial protests by a few parties of the market-based rates of APS and its affiliates (which protests were later withdrawn), FERC imposed standard, but stringent *ex parte* limits that prohibited virtually all direct communications between FERC staff and APS personnel doing the SIL studies. Although a few publicly-noticed technical conference meetings were held, FERC staff refused in those meetings to discuss any aspect of their analyses or to provide their studies to APS and the other parties. FERC did request supplemental information from APS at various points in the process, and APS responded fully and completely to those requests. APS was not informed of any specific deficiencies of the SIL calculations, and instead was encouraged to "cover all the bases." To this day, APS and its affiliates have never seen any studies performed by FERC staff and have never been informed of any calculations by FERC staff of its simultaneous transmission import capability limits for the APS control area.⁴

² The market power screens were adopted by FERC in 2004 as a means to determine if a seller has the potential to exercise market power and utilities are required to pass them to continue to make wholesale sales at market based rates. Failure of any of the screens results in rebuttable presumption that seller has potential to exercise market power. Such failure does not mean that the seller has actually exercised any market power, however.

³ April 17 Order, dissent of Chairman Kelliher at 3. In footnote 54 Chairman Kelliher states that he personally reviewed communication by FERC with other utilities with respect to deficiencies in their SIL calculations and found them, unlike the communications to APS and its affiliates, to contain clear written instructions on how the studies were deficient.

⁴ Although FERC discusses only the APS control area studies in its April 17 Order, APS and its affiliates also proposed a combined APS/Salt River Project combined area as the more appropriate market for analysis. As with other aspects of the order, FERC does not even address this proposal in any substantive way, even though APS and its affiliates demonstrated that they would pass FERC's market screens by a wide margin, thereby providing substantial headroom for any potential concerns in the SIL analyses.

Again, these are highly technical, complex calculations that are based on a methodology that FERC defined based on operations in the Eastern Interconnection. This methodology has been difficult for APS as well as other western utilities to apply to their systems because of the differing operations within the Western Interconnection. Review of the studies is typically an interactive process where parties go over the studies in detail, reviewing the model and assumptions used. As Chairman Kelliher noted in his dissent, APS and its affiliates had previously "raised their concern about the difficulties they were having with the simultaneous transmission import capability calculations when they stated shortly after the December Order that these calculations 'are extremely technical in nature and depend on accurate data and assumptions. It is difficult enough to reach a common understanding on these issues even with a full sharing of information. Without data on how the [FERC] Commission Staff performed the studies, it is nearly impossible for the Pinnacle West Companies (or any party) to respond accurately and fully to any concerns or problems.'"

APS' SIL studies are not deficient, as alleged by FERC. Again, the focus of the Order is on simultaneous import limits into the APS control area. FERC concluded "that the Revised Study continues to violate the requirements of [the requirements for the SIL study] in the following four respects: (a) the Revised Study did not follow historical operating conditions that represent actual OATT-OASIS practices; (b) the Revised Study used available transmission capacity in Northern Arizona as if it would have been available to the Phoenix Valley; (c) the Revised Study did not use actual, historical load in Northern Arizona; and (d) the Pinnacle West Companies failed to support their selective scaling analysis." In fact, APS and its affiliates submitted studies and supporting factual materials that complied with each of these requirements. This submission included the RMR studies that the ACC requires and to which FERC Staff did not take exception.

With regard to the first alleged deficiency, APS and its affiliates submitted base case studies that did reflect actual operating conditions on the APS system, and also submitted materials demonstrating that the change studies were performed in accordance with standard requirements of the Western Electricity Coordinating Council. Because FERC does not detail any of the historic operating conditions to which it refers, APS is unable to respond further to this allegation.

As for the second allegation, APS performed the SIL analysis for the entire APS control area, as required by FERC regulation. Although not clear from the order, FERC may have concerns with APS' position that scaling up load in the APS control area will reach a limit in the Phoenix Valley before hitting limits in Northern Arizona. In order to determine the limit for the control area as a whole, it is necessary to continue scaling up Northern Arizona load until a limit is reached there. If APS were to stop at the Phoenix limit, the study would be only for the Phoenix Valley and not for the APS control area.

Nevertheless, and in response to a FERC inquiry, APS described in detail the process it had used, and also submitted an SIL study showing the SIL calculation assuming the study was stopped when a transmission limit was reached in the Phoenix Valley. Using this reduced limit, APS and its affiliates still pass the Commission market screens, as demonstrated in market studies submitted to the Commission.

With respect to the third alleged deficiency – not using actual historic load in Northern Arizona – using actual historic load will not hit any transmission limits; there will still be available transmission capability into the APS control area. Again, APS explained this in detail in its submissions to the Commission. But, in addition, APS submitted further sensitivity studies that did use actual peak loads in the APS control area as the SIL number. Thus, actual historic peak loads were used for Northern Arizona and for the Phoenix Valley in this analysis. And again, APS submitted market analyses that demonstrated that it passes the Commission market screens under these very conservative assumptions.

As for the alleged failure to support a selective scaling method (as opposed to the standard proportional scaling), APS and its affiliates did describe and support their scaling methodology. In any event, as noted above, APS and its affiliates demonstrated that they pass the market screens even if proportional scaling is used.

From the sparse descriptions of the alleged deficiencies, it is difficult to discern what led FERC to its conclusions on the SIL issue. However, on page 15 of the order FERC states:

We note that the Pinnacle West Companies concede that "[t]hese figures [the Pinnacle West Companies' import figures] do not reflect transmission capability, but rather the historical load available to be served." Further, the Pinnacle West Companies acknowledge that peak demand is a requirement of Appendix E, but nevertheless argue that "limiting the SIL [simultaneous transmission import capability limit] to peak load is not an appropriate constraint to apply to the SIL calculation." As the Commission stated in the April 14 Order, the screens must be prepared as designed. (Footnotes omitted)

Unfortunately, these comments of APS and its affiliates are taken out of context. They were made in connection with the sensitivity analyses requested by FERC staff and discussed briefly above, where APS artificially reduced its import capability by limiting it to levels reflecting the Phoenix area constraints and peak system loads. Thus, when APS stated that the SIL figures cited "do not reflect transmission capability, but rather historic load available to be served," it meant that the actual simultaneous transmission import capability was higher than that reflected in the sensitivity analysis. Similarly, even though APS takes the position that peak loads are not an appropriate constraint on SIL calculations – and APS provided substantial analyses of why that is so – APS nonetheless provided an SIL study based on historical peak loads, and using those calculations, APS and its affiliates pass the FERC market screens.

Thus, while it seems clear that there has been no "meeting of the minds" between FERC Staff and APS with regard to the SIL limit, it is quite possible that that is the result of a misunderstanding by FERC and its staff of the voluminous material provided by APS and its affiliates as they tried to produce several variations of complex system calculations, which to be fully understood require an intimate knowledge of the system being studied and the methodologies used in the Western Interconnection. To date, the prohibitions on communications have placed severe obstacles to reaching such an understanding. We are hopeful that an open and productive process can take place on rehearing of the order. APS and its affiliates do not have market power and should be permitted to sell excess energy at market-

Commissioners

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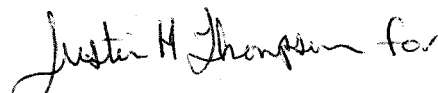
based rates, for the benefit of its native load customers. APS will file a request for rehearing by May 17th on this issue and pursue it vigorously.

FERC also states that APS and its affiliates failed to proposed alternative forms of cost-based mitigation. However, under the procedures adopted by FERC, parties are not required to propose alternative mitigation (or file a Delivered Price Test) until after they are found to violate market screens. Therefore, the typical procedure would be to permit APS to file for alternative mitigation (and/or a Delivered Price Test) at this time. In any event, as is apparent from the portion of the order discussing (but rejecting) APS' proposal to use the Western System Power Pool's cost-based pricing, APS and its affiliates did propose alternative mitigation. APS will pursue this issue on rehearing as well.

Because of the complexity of the calculations required by the order, APS is still working to determine its refund obligation, if any, should the order remain in place and be upheld on appeal. Specifically, the order requires that APS go through a review of all sales in its control area during the approximately fourteen month "refund period", and with respect to each such sale calculate and apply a retroactive cost-of-service "cap" that is dependent on the term of the applicable sale. Components of the retroactive cost-of-service calculation include (depending on the term of any particular sale) an assessment of the fully embedded cost of particular APS units which may have been assigned to make the applicable sale and/or an hour-by-hour "cost" assessment for all shorter-term sales. Going forward, APS will continue its off-system sales in the APS control area under cost-based rates derived from the Western Systems Power Pool agreement (the "WSPP"), as well as sales in markets where it retains market-based rate authority. In fact, most of the sales made within the APS control area can just as easily be made to the same counter-parties at locations outside the APS control area (e.g., Palo Verde).

If you have any questions on this summary, please give me a call.

Sincerely,


Barbara Klemstine

Cc: Brian McNeil
Ernest Johnson
Matt Rowell
Chris Kempley
Janice Alward
Parties of Record in Docket